AUDITOR GENERAL
Alberta

Examination of Internal Audit Departments

August 31, 2005

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For the year ended March 31, 2005

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1. Summary

Background

We found that stakeholders in both the public and private sector increasingly value the oversight role performed by audit committees. Professional literature on governance often refers to this role as a fundamental part of sound governance. For example, an audit committee's role often includes the oversight of risk management and internal control systems, two critical elements for good governance. To fulfill their oversight responsibilities audit committees need assurance that all significant risks have been identified and effectively mitigated. Audit committees look to their organization's internal audit department as an important source of the needed assurance[1]. Audit committees need to set clear expectations for internal audit departments including that the departments conform to International Standards for the Professional Practice of Internal Audit (IIA Standards).

Not-for-profit and smaller private sector entities are also being challenged by stakeholders to demonstrate that they have appropriate risk assessment and mitigation systems.

This changed environment has reemphasized three common challenges that audit committees and management ask internal audit departments to meet:

- add more value, by
  - expanding internal audit coverage of key business risks, including the risk of not achieving value of money
  - providing early warning of new exposures facing the organizations
  - auditing more complex, integrated and automated information systems
- provide more comprehensive risk coverage
- operate more efficiently

In requesting more value of the internal audit departments, audit committees and management recognize that internal audit departments will have to attract more knowledgeable auditors. Successful internal audit departments are led by well trained business orientated internal audit professionals who understand the need to focus on key risks of the organization. These professionals determine and guide the entire internal audit department with respect to direction, focus, and internal audit processes. Internal audit professionals may not come with traditional internal audit backgrounds.

Successful internal auditor professionals demonstrate the following characteristics:

- The ability to align the structure of internal audit with the dynamics of the organization and balance internal audit resources to risk.
- Strong relationship management skills for maintaining appropriate visibility and alignment with key stakeholders, management, and audit committee needs and expectations.

[1] Audit committees will also receive assurance from external audit, management, personal observation and other external advisors.

- Strong service delivery capabilities (consistency in approach, standards, and delivery), including the abilities to maintain audit focus and alignment of resources to the plan.
- Strong people management skills which include ensuring internal audit teams have appropriately skilled and motivated staff.

The Alberta public service recognizes the importance of internal audit. A number of organizations, such as the Universities of Alberta and Calgary, the Workers' Compensation Board and ATB Financial have had internal audit departments for many years. In May 2003, the Alberta government established the Office of the Chief Internal Auditor (OCIA). The OCIA provides internal audit services to all government ministries. Other Alberta public sector organizations have recently established or are now establishing internal audit departments.

As a result of the changes within internal audit, we decided to examine the performance of internal audit departments in Alberta public sector organizations. In particular, we assessed the operation of the 11 departments selected (9 were examined in detail) against leading internal audit practices. (See Appendix A – Internal audit departments examined)

Recommendation

We recommend that the Deputy Minister of Executive Council provide audit committees with guidance for overseeing internal audit departments, including identifying related training.

Our key conclusions

In general, internal audit departments need to improve, in some cases significantly. This is not surprising for new internal audit departments. To assist each organization audited, we provided them with a copy of our overall report and a report tailored to their situation. In the report specific to the organization, we included recommendations on areas the internal audit department needed to improve.

A common theme evolved from our work: audit committees need to support their internal audit departments by:

- setting clear performance expectations focused on results
- ensuring terms of reference for the audit committee and for internal audit are aligned and consistent with IIA Standards
- demanding that internal audit practices in their organization comply with IIA Standards and follow best practices
- requiring auditors to focus on key risks of the organization
- ensuring that the department has the necessary resources to meet their terms of reference

The need to champion internal audit will require audit committees to recognize that internal audit is an important resource to them, to actively work with leaders of internal audit and to gain a deeper understanding of internal audit standards.

Public sector internal audit departments can improve their effectiveness and efficiency by implementing best practices and improving relationships with management. They should also adopt policies and procedures that clearly define their audit methodology and performance expectations and include a code of conduct.

As a significant stakeholder, the government has a role in assisting audit committees in their oversight of internal audit departments in the public sector.

Criteria: the standards we used in our audit

We developed criteria that, in our opinion, if met by an internal audit department would demonstrate that it was effective, complied with IIA Standards and met best practices. We drew the criteria from sources such as the pronouncements of the Institute of Internal Auditors (IIA), Auditors General in other jurisdictions, and current literature. We provided the criteria to each organization we audited for their comments. All the organizations generally agreed with our criteria (See Appendix B). The criteria, addressed the areas of:

- Audit committees expectations, direction and accountabilities
- Relationship of internal audit departments to their organization
- Internal audit skills, capabilities and audit approach

Our audit findings

The quality of audit work varied among the internal audit departments we examined. Newer departments generally had better terms of reference, but lacked resources and the required skills. Well established departments tended to be further along in developing policies and procedures and in assessing risks across their organization. However, all departments face the challenge of adapting their practices in areas where the IIA has provided new guidance. We noted some good practices and examples of effective auditing. We also observed that internal audit departments are willing to work together to share good practices.

As we have stated in other reports on governance, a great deal of change is occurring with governance. The pressure for change is affecting internal audit departments. Our findings are consistent with the observation that internal auditors, in many cases, are at the start of the change. The balance of the report has more detailed information.

Audit committee's expectations, direction and accountabilities

A couple of the internal audit departments we examined do not have terms of reference in place that define the purpose, authority and responsibility of the internal audit department. There is not proper alignment between the terms of references of internal audit departments, the terms of reference of audit committees and management practices, in many cases. None of the terms of references require internal audit departments to develop long-term strategic plans and most do not require any reporting against agreed to performance measures. A long-term internal audit plan is essential to demonstrate alignment of proposed audits to the organization's risks, highlight strategic internal audit initiatives and develop annual audit plans.

In a few cases, internal audit is performing management functions that could impair the independence and objectivity of the internal audit department. There are also three cases where internal audit departments' independence is compromised as internal audit leaders either do not report directly to audit committees, or do not meet regularly with their audit committees. Internal audit departments should be organizationally independent of management and report directly to audit committees.

We did observe a good practice in that two of the leaders of internal audit departments had regular monthly meetings with the Chair of their audit committee to discuss developments and progress.

The internal audit plans we examined were often only lists of intended projects making it difficult for audit committees to determine whether the plans are risk-based, or if there are resource or skills gaps. Four of nine internal audit departments we examined have defined their audit universe[2] and have completed a risk assessment. But they have not prepared a long-term plan. A long-term plan would provide the audit committee and management with information linking the audit universe to the planned audits. Through effective risk assessments and planning, internal audit can show that it is focusing on the key risks that matter to the organization. Also, plans will demonstrate the connection between the focus of internal audit and the organizations' business objectives.

Internal audit departments are not regularly reporting to audit committees on progress against their plan. Regular reporting allows audit committees to assess internal audit's effectiveness, priorities and resource allocation.

Relationship of internal audit departments to their organization

Key executives in more than half the organizations and audit committees in a third of the organizations stated that they expected more value from internal audit. We also heard from three internal audit leaders that their department would benefit from increased support from senior management or their audit committees. If the internal audit department does not show that it can add value, its recommendations may not be implemented. Thus, significant risks may not be mitigated.

A co-developed approach to assessing risk, project planning that involves both the internal audit department and management, and vetting recommendations with the audit committee and senior management would increase the success of internal audit departments in showing value. We also heard from management and audit committees that they valued timely internal audit reports. Two internal audit departments did not complete significant audits promptly. Few departments disclosed in their reports that they followed IIA standards or rated recommendations as low-, medium-, or high-risk to make audit reports more meaningful to the readers.

Our sample of 11 audit files from 3 organizations indicated that the internal audit departments' recommendations were supported by audit evidence and were generally

[2] Audit universe is defined as a collection of all the processes, programs, projects and other units of the organization that are relevant to the strategic plan and have sufficient importance and/or significance to achieving the plan.

accepted by management. However, given the deficiencies in the project plans we were unable to determine if all possible issues were identified in the audits.

Internal audit skills, capabilities and audit approach

Only four internal audit departments have developed a code of conduct that adequately covers the four principles appropriate for internal auditors—integrity, objectivity, confidentiality and competency. Although many of the organizations audited had a corporate code of conduct and the IIA has a code of ethics, internal audit departments should supplement these codes with a code of conduct that takes into account the uniqueness of the internal audit department and its function within the particular organization. Internal auditors should sign an annual commitment to these codes.

Over half of the audit departments indicated that they needed auditors with specialized skills; for example, skills for auditing information technology systems, risk management processes, and specialized financial transactions specific to the organization. Three organizations were recruiting an internal audit leader. Two organizations indicated that they wanted to increase their internal audit resources. One department did not have an adequate plan for their training requirements.

Fewer than half of the departments examined had adequate documentation of their policies, procedures and audit methodology to provide their internal auditor staff with the necessary level of guidance and support. One third of the departments we examined are now documenting or updating their policies, procedures and audit methodologies.

Only one internal audit department had carried out a quality assurance program. That department carried out a self-assessment which did not involve an independent review. The IIA Standards require an independent review at least every five years. Quality assurance programs provide internal audit leaders and audit committees with assurance that internal audit practices meet IIA Standards. Our sample of 11 audit files indicated that internal audit departments need to consistently document their project risk assessments, the criteria used for individual audits, and the audit file reviews. A quality assurance program would reinforce the need for internal audit staff to comply with these and other standards and leading practices.

Implications and risks

Audit committees increasingly rely on internal audit for assurance on the design and operating effectiveness of organizations' systems of internal control. If internal audit departments do not follow their profession's standards or adopt relevant best practice, then this reliance may be unwarranted. Also, audit committees may not be aware of potentially significant risks or risks that have not been mitigated. Thus, audit committees may not fulfill their mandate and the organization may not achieve it objectives.

2. Introduction

Recently the practice of internal audit has received greater focus as regulators require companies to assess and improve their internal controls in response to recent corporate failures. New rules issued by regulators for private sector (listed companies) require that a company have a strong internal audit department. Internal auditors assist their companies in meeting the new regulations. For example, listed companies are now required to report publicly on their internal financial reporting (or accounting) control. Internal auditors examine and report to management on these control systems and thus enable management to meet their disclosure requirements.

The renewed emphasis on ensuring that a company had sound internal control systems has also affected audit committees. Audit committees have traditionally had oversight responsibility for internal control systems within their mandate. The emphasis placed on disclosure has heightened their interest in this area of their mandate. Internal audit also plays a critical role in providing audit committees with objective assurance on the design and effectiveness of these systems.

A 2005 survey by Ernst & Young LLP shows that many large private sector organizations will increase their internal audit budget by more than 25% over the next 12 months.

Not-for-profit and smaller private sector organizations are also being challenged by stakeholders to demonstrate that their risk assessment and risk mitigation systems meet best practice.

The Alberta public service recognizes the importance of internal audit. A number of organizations, such as the Universities of Alberta and Calgary, the Workers' Compensation Board and ATB Financial have had internal audit departments for many years. In May 2003, the Alberta government established the Office of the Chief Internal Auditor (OCIA). The OCIA provides internal audit services to all government ministries. Other Alberta public sector organizations have recently established or are now establishing internal audit departments.

This changed environment has lead to three common challenges that audit committees and management are asking internal audit departments to address: provide more value; provide more comprehensive risk coverage and operate more efficiently.

The profession of internal audit is managed through the Institute of Internal Auditors. The Institute's *International Standards for the Professional Practice of Internal Auditing* (IIA Standards) guides all internal audit professionals. The Institute also provides training to internal auditors and certifies that they meet an acceptable level of proficiency. The work of the Institute provides a sound foundation for internal auditors to meet the new challenges discussed above.

3. Scope and approach of the audit

The objective of our audit was to assess the performance of internal audit departments in the Alberta public sector against the criteria we developed.

The audit covered 11 internal audit departments in the Government of Alberta and its related organizations (see Appendix A), of which nine were covered in detail. For three of these nine we carried out a detailed examination of a sample of audit files. Our approach was to focus our audit work based on a risk assessment that separated internal audit departments into high-, medium-, and low-risk groups based on the following attributes:

- complexity of the organization in terms of size, decentralized management, nature of operations
- complexity of the financial reporting requirements of the organization;
- community impact of the organization
- public visibility of the organization
- volume of transactions processed by the organization
- total budget for the organization
- past performance of the organization in achieving its mandate
- complexity of the legislation under which the organization operates
- size of the internal audit department

Our audit procedures were tailored to the individual internal audit department, based on our risk assessment of the organization. The procedures included:

- interviewing representatives of organizations including audit committee members, senior management of the organization, and its internal audit department
- examining related documents, including the audit committee terms-of-reference, the internal audit terms-of-reference, internal audit files, meeting minutes and information packages
- surveying internal auditors and representatives of the organization or the audit committee

In all departments examined, an audit committee exists to oversee internal audit. The Alberta government has established a committee of deputy ministers and two private sector executives to act as an audit committee. Since there is no "board of directors" like a private sector company, we consider this to be a reasonable approach.

Criteria

We developed criteria that, in our opinion, if met by an internal audit department would demonstrate that it was effective, complied with IIA Standards and met best practices. The criteria come from sources such as the pronouncements of the Institute of Internal Auditors, Auditors General in other jurisdictions, and current literature. We provided the criteria to each organization we were auditing for their comments. All the organizations generally agreed with our criteria. The criteria, and the sources we used to develop them, are set out in detail in Appendix B. The main audit criteria are set out in the following sections.

4. Audit committees expectations, direction and accountabilities

Audit committees, or the equivalent[3], (collectively, audit committees) are key committees supporting an organization's overall governance. Internal audit should be an important resource to enable audit committees to fulfil their responsibilities by providing them with independent assurance on subjects such as the effective design and operation of the systems of internal control, the effectiveness of operations, accuracy of financial reporting and the organization's compliance with legislation.

The Alberta government recognizes the importance of the internal audit function to public sector audit committees. In April 2005 the Alberta government published guidance in a document entitled *Proposed Guidance for Audit Committees of Government of Alberta Agencies, Boards and Commissions*. The document states that its purpose is to provide boards of directors with information on discharging their responsibilities. The guidance points out the importance of an audit committee, and explains that its role is to assist the Board and the Board Chair in monitoring the corporate governance processes, accountability processes and control systems in the agency. The guidance also stresses that audit committee members should have appropriate skills to allow them to carry out their mandate. Such skills include a sufficient understanding of current practices of internal audit to allow the committee to assess the value and assurance provided by the internal audit department.

Our results

Audit committees, in conjunction with senior management, need to define the extent to which they will rely on the work of internal audit to fulfil their governance responsibilities. They also need to determine the other work that is within the scope of internal audit (investigations and consulting) and the proportion of time to be spent on internal audit versus this other work. Audit committees need to ensure that the expectations they identified are clearly set out in the committee terms of reference, the internal audit department terms of reference and internal audit plans.

Criteria: the standards we used for our audit

1. The organization, including their respective audit committee (or equivalent) should formally document and communicate their expectations of an internal audit department. The organization should consider the ability to attract and retain qualified individuals when considering the size and scope of the internal audit department and when deciding whether it is more cost effective to outsource or maintain the function internally.
2. Terms of reference should formally define and document the purpose, authority and responsibility of the internal audit department.
3. Internal audit should be organizationally independent of management.

[3] Organizations may assign responsibility for the audit committee function to committees such as a finance committee or may retain it as a responsibility of the whole board.

4. The relationship between audit committees and internal audit departments should be formalized and cover the department's terms of reference, resourcing, periodic plans and progress reports against plans, adequacy of management's response to advice and recommendations, arrangements for quality assurance and performance management processes and other matters significant to the operations of the department.

5. Internal audit should establish risk-based plans, annual and long-term, to determine the priorities of the internal audit department and to highlight shortfalls in resources. The plans should be approved by the audit committee and the internal audit department should report progress against the plan to the committee.

Our audit findings

Mandate of internal audit department

The relationship between audit committees and internal audit departments should be formalized in the terms of reference of the audit committee and the terms of reference of the department. This will ensure that there is a clear understanding of the degree to which, and areas where, audit committees will rely on the work of internal audit. Audit committees should ensure that internal audit's terms of reference meets their requirements and reflects current best practices.

We assessed the terms of references for the nine internal audit departments we examined in detail. We determined that they did not always meet best practice nor did they always reflect the work actually carried out by the internal audit departments. Our findings include:

- Two departments did not have terms of reference although one has a draft terms of reference which the audit committee intends to approve at its next meeting. We also observed that the terms of reference of another department had not been updated since 1979.

- None of the terms of references require the development of long term or strategic plans and only one requires reporting against agreed to performance measures. As a result, none of the audit departments had a strategic plan or report against Key Performance Indicators (KPIs) (although we were told that some are developing them). One internal audit department prepares a two year plan and one had components of a long term plan; all the others prepare only annual plans. A long-term plan demonstrates alignment with the organization's plans. Some of the strategic initiatives that could be covered are succession planning, management development, current or potential audit resource needs, and changes to audit approaches, methods, and identification of all major risks. Best practice is to define KPIs. KPIs focus more on what is created, not what is consumed, and should be co-developed with the stakeholders. Specific targets should be set by internal audit departments and agreed to by audit committees for each KPI (see Appendix C for a sample of key performance indicators).

- The terms of reference of internal audit should be aligned with the terms of reference of the audit committee and the management practices of the organization. We found a few cases where the terms of references of internal audit and the audit committee

were not aligned. For example, the terms of reference of one department indicated that the audit committee provides general direction as to the nature of audits to be carried out, whereas the terms of reference of the audit committee states that it approves the audit plan. The terms of reference of the audit committee of another organization contains a requirement that it review the annual plan including the risk assessment, while the terms of reference of the internal audit department requires that the annual plan be approved by the audit committee.

- More notable was the lack of alignment between the terms of reference of internal audit and management practices. The six current terms of references of internal audit departments contain the requirement to provide assurance over the organization's enterprise risk management processes and to test the controls identified by management. However, only three organizations have completed an enterprise risk assessment with the form and content suitable for the internal audit department to meet the terms of their mandate.
- Most terms of references specify that, for the purposes of maintaining independence and objectivity, internal audit should not perform functions that are operational. The actual work performed included areas that were the responsibility of management, or involved making management decisions. In two cases this made up a significant proportion of the total work performed by the internal audit department.

Of the six internal audit departments with up-to-date terms of references, we found:

	Number of internal audit departments	**%**
Terms of reference of internal audit includes the requirement that the audit committee review the audit plan	5	83%
Terms of reference of the audit committee requires that it review the audit plan	6	100%

Organizational independence

Internal audit should provide independent assurance to the audit committee. If internal audit departments are not independent of the management that they audit, then audit committees will not receive the objective assurance they need. To ensure internal audit independence, it must report directly to the audit committee and the audit committee must ensure that management supervision has not compromised the internal auditor's independence. While internal audit must provide reports to management, leading practices recognize the primary stakeholder of the internal audit department is the audit committee. As mentioned, we observed internal auditors carrying out projects that seemed operational in nature. Also, two of internal audit departments reported to a senior executive. Internal audit departments must report to a senior executive for certain administrative matters. However, we concluded that in a few cases the senior executive was sufficiently involved in internal audit operations to risk compromising its independence.

The Chair of the audit committee should meet with the leader of internal audit regularly. One of the leaders of internal audit advised us that he was discouraged from talking to the Chair. The Chair should initiate the meetings to ensure that management is not putting pressure on internal audit not to meet with the audit committee. Another leader of internal audit indicated that he was not invited to attend all meetings of the audit committee. Furthermore, private "in camera" sessions between audit committees and internal audit did not always take place. In both of these instances, the leader of internal audit did not report directly to the audit committee.

The following table reflects the number of internal audit departments complying with best practice in the area of organizational independence:

	Number of internal audit departments	%
Report to Audit Committee	5	56%
Meet regularly with the Chair of the Audit Committee (defined as at least quarterly)	7	78%
Regular reporting to Audit Committee (defined as at least quarterly),	7	78%
Perform no management functions	8	89%

Audit plans and resourcing

The audit planning process is a critical process for internal audit departments. As the primary stakeholder, audit committees must ensure that internal audit plans are developed from a current assessment of actual and inherent risks facing the organization, and key stakeholders expectations are met as demonstrated by their agreement with the plan. Internal audit departments must demonstrate that plans are driven by risk, not resources available.

Good internal audit plans provide information to support the underlying strategies, reconcile budgetary and resource constraints, provide effective coverage through a balanced portfolio of internal audit activity and respond to any changes in internal audit focus, process or strategy. Also, these plans demonstrate that internal audit will focus on the risks that are important to the organization and on the organization's business objectives. These plans will bring together the results of an effective risk assessment with a clear assessment of the audit universe. An effective risk assessment should be based on real risks facing the organization and be continually updated. An audit universe is "a collection of all the processes, programs, projects and other units of the organization that are relevant to the strategic plan and have sufficient importance and/or significance to plan achievement".[4]

[4] Risk Management: Defining a New Paradign for Internal Auditors by David McNamee and Georges Selim see www.mc2consulting.com

The internal audit department should have both annual and long-term plans. The annual plan sets out specific audits to be carried out in the period, the available resources and any resource gaps. A long-term plan states when the audits in its audit universe will be carried out based on the risk assessments. Audit committees will use long-term plans to satisfy themselves that internal audit has prioritized the work appropriately. The annual plan provides any information necessary for audit committees to assess the risk associated with a lack of resources. From a practical perspective, it is important that internal audit plans are presented in an appropriate level of detail to reconcile budgetary and resource constraints, and allow audit committees to hold the leader of internal audit accountable for meeting plan goals.

Our observations in this section take into account that not all of the organizations had finalized their enterprise risk assessments. Nevertheless, internal audit should carry out a risk assessment to identify or clarify its audit universe and to present this to the audit committee. If the organization has conducted an enterprise risk assessment, then the internal audit department should use it to develop the audit universe and prepare its annual and long-term plans.

Of the nine internal audit departments examined in detail we found:

	Number of internal audit departments	**%**
Have documented and discussed its risk assessment and audit universe with the audit committee.	2	22%
Prepared comprehensive long-term plans linked to its audit universe	0 (although one had a two year plan)	0%
Demonstrate links between risk assessment and annual audit plan	2	22%
Audit plan discloses the impact of resource gaps in terms of audits that should be completed during the current year, from a risk perspective, but deferred due to resource constraints	0	0%

Aside from two internal audit departments, the audit plans presented to audit committees were lists of the projects that would be covered by the available person-days. Internal audit departments therefore were not able to demonstrate to audit committees that their annual audit plans were risk based. In addition, some of the plans contained projects requested by management or activities that are the responsibility of management. However, the nature and importance of the project was not always clear from the plan.

Reporting

Internal audit departments were not always providing regular reporting on progress against the annual plan to the audit committees (regular has been defined by the IIA as at least once a quarter). If audit committee meetings are not being held on a quarterly basis then audit committees should consider doing so; otherwise, audit committees may not be aware of inappropriate responses to recommendations or other issues that should be dealt with promptly. In addition, regular reporting could highlight instances where the internal audit departments are unlikely to achieve their audit plan because of projects carried out for management. For instance, one internal audit department was unable to complete planned projects representing 23% of the total hours budgeted in its plan. Although certain projects were deferred because the timing was no longer appropriate, a large proportion of the time lost was due to special investigations and project work for management carried out during the year. If quarterly reporting had taken place, the audit committee would have been able to confirm or challenge the internal audit plan changes.

Implications and risks

Internal audit's ability to provide the assurance required by the audit committee is jeopardized when internal audit does not meet best practices. The service and deliverables provided by internal audit may not meet the needs of the audit committee or management. The audit committee may place unwarranted reliance on the work of internal audit in concluding on, and the audit committee may be unaware of, significant risks.

5. Relationship of internal audit departments to the organization

The primary stakeholder of the internal auditor department is the audit committee. However management and others in the organization are also stakeholders. Best practice in managing relationships with all stakeholders embodies a common theme of "co-development" whereby each stakeholder's expectations for internal audit services are stated, understood, assessed and agreed. Leading internal audit departments recognize that this co-development approach also applies to ongoing activities and interaction of internal audit with management.

To be successful, it is not enough simply to identify issues; internal audit departments must effect a change of risk management behaviour and activities where issues have been identified. Change management techniques highlight that this is best achieved through open communication, leadership and clarity of benefits. Virtually every stage of the service delivery process should be agreed with management, including risk assessment and execution.

Our results

Leaders of internal audit need to establish processes to obtain an understanding of the expectations of management of the organizations being audited and to allow the management to understand the services that internal audit provides.

Criteria: the standards we used for our audit

1. The terms of reference should cover relationships with other executives in the organization.
2. Internal audit should evaluate and contribute to the improvement of risk management, control and governance processes using a systematic and disciplined approach.
3. Reports should provide accurate, objective, complete and timely information. Reports should be written such that they are easily understood and useful to management in developing their implementation plan of action. Follow-up audits should be performed within 2 or 3 years and should address all prior recommendations.

Our audit findings

We reviewed the responses to our survey sent to the chair of audit committees, leaders of internal audit and senior management. We received comments that expressed concern with the performance, capabilities of internal audit or a perceived lack of value. Leaders of internal audit expressed concern that senior management's actions impaired their ability to act independently. Of the nine internal audit departments selected for further examination:

	Number	%
Chair of audit committee expressed concerns over internal audit performance or the value generated.	3	33%
Senior management expressed concerns over internal audit performance or the value generated.	4	44%
Leaders internal audit department expressed concerns related to senior management interference, to whom the department reports or their ability to act independently.	3	33%

Implications and risks

If the internal audit department does not demonstrate that it can add value, it may not effect change (recommendations may not be implemented which could result in losses and no improvement in control systems and efficiency of the organization). The lack of independence, real or perceived, can jeopardize the ability of the audit committee to rely on the work of internal audit.

6. Skills, capabilities and audit approach

Leading internal audit departments recognize the importance of highly effective, efficient and consistently performed audits. The key features of leading internal audit departments are that they meet the expectation of the audit committee and management, operate with integrity, implement best practices and comply with IIA standards.

Our results

Leaders of internal audit need to make the following changes to improve the effectiveness of their department and ensure that audits are performed in compliance with professional standards. These changes are:

- implement a code of conduct covering the four principles of integrity, objectivity, competence and confidentiality and a process to provide assurance that the code is being followed by all internal audit staff
- carry out a quality assurance program and communicate the results to the audit committee
- document the departments policies and procedures and its audit methodology, including the approach to identifying and testing information technology based controls
- ensure that project plans are based on a risk assessment and the risk assessment is documented in the file and discussed with management
- document the detailed criteria which were discussed with management before starting the audit
- improve on the timeliness of delivery of audit findings and reports

Criteria: the standards we used for our audit

1. Internal audit should have a code of conduct covering the four principles of integrity, objectivity, competence and confidentiality and a process to provide assurance that the code is being followed.
2. Internal audit should have the capacity to accomplish its responsibilities, have processes to maintain its auditors' skill, and collectively possess the requisite skills for all audits.
3. Internal audit should comply with professional standards for developing criteria for audits; for planning, executing, and documenting audits; and reviewing audit files.
4. Internal audit work should be carried out with due professional care.
5. The leader of the internal audit department should develop and carry out a quality assurance and improvement program.

Our audit findings

Required resources

A critical element for effective internal audit service is determining the skills required to execute the internal audit plan and then delivering these required resources. The quality of audit assurance will be high if the skills required to deliver the plan are available or obtained. Of the nine internal audit departments we examined in detail, three indicated they had difficulty attracting and retaining qualified individuals for approved positions. Also, three were recruiting a leader for their internal audit department.

In five of the departments examined, senior management expressed concern that the internal audit department did not have sufficient knowledge of information technology and that the department was not doing sufficient work in that area. The audit plans did not disclose the total resource gap (the impact of not having the correct complement of staff in approved positions or attracting the individuals they require). None of the organizations

and their audit committee considered the costs and benefits of maintaining the internal audit function internally compared to the cost and benefits of outsourcing. However, most departments contracted to obtain a portion of their resources.

Code of conduct or ethics

The Institute of Internal Auditors states "a code of ethics is necessary and appropriate for the profession of internal auditors, founded as it is on the trust placed in its objective assurance about risk management, control and governance." This principle also applies to the requirement for a code of conduct for an internal audit department. The purpose of a code of conduct is to communicate the integrity, objectivity, confidentiality and competence expected of internal auditors. Also, internal auditors should confirm their commitment to these principles by signing an annual confirmation and audit committees should be advised of any non-compliance.

Many of the internal audit departments stated that they are required to comply with the codes of conduct of the organization and/or that of their professional institute, or both. These departments considered that developing a code of conduct specific to their department would duplicate efforts. However, the codes of conduct for the organization did not adequately cover all the principles appropriate for internal auditors. Furthermore, most of the organizations' codes of conduct did not require annual confirmation. Only four of the nine we examined in detail had a code of conduct; of these, two required an annual confirmation.

Documentation of methodology, policies and procedures

All internal audit leaders recognize the importance of highly effective, efficient and consistently performed internal audits. Leading internal audit executives recognize that to achieve this goal, they need to provide their auditors the necessary level of guidance and support. It is important that the methodology be documented in a manner that can be updated easily to reflect organizational change, changes in internal audit focus or strategy, and changes in internal audit processes. Also, documentation must state the methodology in sufficient detail and clarity to guide an internal audit member through the majority of their activities in a typical audit.

We found that:

	Number of internal audit departments in compliance	**%**
Documented policies and procedures	3	33%
Documented audit methodology	4	44%
In process of documenting policies and procedures and methodology	3	33%

Internal auditors should conduct a preliminary assessment of the risks relevant to the activity under review. Adequate criteria are needed to evaluate controls and governance processes and to assess value-for-money. We selected a sample of 16 audits from 5 internal

audit departments and found that all had project audit plans. Of these plans, 11 did not have criteria and 9 contained no evidence of a risk assessment.

We carried out a detailed examination of 11 audit files in 3 internal audit departments and we found that in all cases evidence in the files supported the audit reports and in most cases management agreed with the results. In two cases, files were not put together well; therefore evidence was harder to locate. However, given the deficiencies in the project audit plans we were unable to determine if all possible issues were identified in the audits.

Quality assurance programs

Internal audit should carry out a quality assurance program to ensure that they maintain appropriate standards. The results should be reported to the audit committee by internal audit leaders along with the plan for rectifying any weaknesses. To date, only one internal audit department has carried a quality assurance program. The one completed did not include an independent assessment.

Implications and risks

In absence of correct resources, articulated codes of conduct and quality assurance programs that assess compliance with professional standards, there is a risk the internal audit department will not be effective.

Internal Audit Departments Examined

AUDITOR GENERAL Alberta

Scope of audit

Completed all procedures including file examination:

- ATB Financial
- Office of the Chief Internal Auditor
- Workers' Compensation Board

Completed all procedures except detailed file examination:

- Agricultural Financial Services Corporation
- Alberta Finance – Alberta Investment Management
- Capital Health
- Alberta Energy and Utilities Board
- University of Alberta
- University of Calgary

Limited work was performed on:

- Southern Alberta Institute of Technology
- University of Lethbridge

Criteria used in the Assessment of Internal Audit Function

AUDITOR GENERAL Alberta

1. The organization, including their respective audit committee (or equivalent) should formally document and communicate their expectations of an internal audit department. The organization should consider the ability to attract and retain qualified individuals when considering the size and scope of the internal audit department and when deciding whether it is more cost effective to outsource or maintain the function internally.

2. Terms of reference should formally define and document the purpose, authority and responsibility of the internal audit department. The terms of reference should:

   2.1 Define the nature of assurance services provided to the organization.

   2.2 Define the nature of consulting services provided to the organization.

   2.3 Define objectives, roles, responsibilities, authority and accountabilities.

   2.4 Define the organizational independence of internal audit.

   2.5 Establish the group's right of access to all records, assets, personnel and premises and its authority to obtain such information and explanations as it considers necessary to fulfill its responsibilities.

   2.6 Specify the requirements for the professional skills and experience of the leader of internal audit (or equivalent title).

   2.7 Be consistent with the terms of reference of the audit committee.

   2.8 Be approved by the board or audit committee.

   2.9 Be periodically reviewed by the audit committee and updated, at least every three years.

   2.10 Cover all significant functions and operations.

   2.11 Cover standards and retention requirements for all audit records and documentation, consider the Freedom of Information and Protection of Privacy Act, and control access to records.

3. Internal audit should be organizationally independent of management.

   3.1 The internal audit group should report functionally to the audit committee or equivalent. Administratively, the internal audit group should report to a sufficiently high executive level, with key decisions made by the Audit committee (i.e. internal audits budget).

   3.2 The internal audit department should be free from interference in determining the scope of internal auditing, performing work, and communicating results.

   3.3 The audit committee should review and endorse the appointment or replacement of the leader of internal audit.

   3.4 Assurance engagements for functions over which the leader of internal audit has responsibility should be overseen by a party outside the internal audit department.

4. The relationship between audit committees and internal audit departments should be formalized and cover the department's terms of reference, resourcing, periodic plans and progress reports against plans, adequacy of management's response to advice and recommendations, arrangements for quality assurance and performance management processes and other matters significant to the operations of the department.

5. Internal audit should establish risk-based plans, annual and long-term, to determine the priorities of the internal audit department and to highlight shortfalls in resources. The plans should be approved by the audit committee and the internal audit department should report progress against the plan to the committee.

   5.1 Annual and long-term audit plans should be prepared.

   5.2 The internal audit plan should establish risk-based plans to determine the priorities of the internal audit department, consistent with the organization's goal.

   5.3 The input of senior management and the board / audit committee should be considered in this process and the agreed outcomes should be documented in the plans.

   5.4 The Impacts of limited resources should be communicated to the audit committee.

   5.5 The leader of internal audit should ensure that internal audit resources are appropriate, sufficient and effectively deployed to achieve the approved plan.

   5.6 Project budgets should be based on short and long-term audit plans and should be sufficient to carry out work plans.

   5.7 The leader of internal audit should report periodically to the audit committee, the board and senior management on the internal audit department's purpose, authority, responsibility and performance relative to the agreed key results areas in audit plans. Reporting should also include significant risk exposures and control issues, corporate governance issues, and other matters needed or requested by the parties.

6. The terms of reference should cover relationships with other executives in the organization:

   6.1 Establish the reporting lines and relationships between the leader of Internal Audit and those charged with governance as well as those parties to whom the position may report.

   6.2 Ensure senior management keeps the leader of internal audit informed of strategic and business plans by granting sufficient access to related meetings.

7. Internal audit should evaluate and contribute to the improvement of risk management, control and governance processes using a systematic and disciplined approach.

   7.1 The internal audit department should evaluate and report on the effectiveness of the organization's risk management system.

   7.2 Based on the results of the risk assessment, the internal audit department should evaluate the adequacy and effectiveness of controls encompassing the organization's governance, operations, and information systems. This should include:

      7.2.1 Reliability and integrity of financial and operational information.

      7.2.2 Effectiveness and efficiency of operations.

      7.2.3 Safeguarding of assets.

      7.2.4 Compliance with laws, regulations, and contracts.

      7.2.5 Work is completed within the target dates and expectations.

8. Reports should provide accurate, objective, complete and timely information. Reports should be written clearly so that they are easily understood and useful to management in developing their implantation plans. Follow-up audits should be performed within 2 or 3 years and should cover all prior recommendations.

   8.1 The audit report should describe the scope, identify the criteria, describe findings which form the basis for the internal auditor's conclusions, and state whether IIA standards were followed.

   8.2 Audit reports should be formally issued shortly after the audit has been completed.

   8.3 The report should rate recommendations as high, medium, and low in order to assist management in assigning priorities for action to the issues raised.

   8.4 The report should be discussed with management responsible for the area for confirmation of factual accuracy.

   8.5 The internal audit department should try to obtain management's agreement with recommendations before a final report is issued. Any areas of disagreements between the auditor and management that cannot be resolved should be recorded in the report/action plan.

   8.6 Management should provide comments on how it will deal with the recommendations.

   8.7 The internal audit department should have a follow-up process to monitor and ensure that management actions have been effectively implemented or that senior management has accepted the risk of not taking action.

   8.8 The leader of internal audit should develop escalation procedures for any management responses that are judged to be inadequate in relation to the identified risk. These procedures should ensure that the risks of not taking action have been understood and accepted at a sufficiently senior management level.

9. Internal audit should have a code of conduct covering the four principles of integrity, objectivity, competence and confidentiality and a process to provide assurance that the code is being followed.

   9.1 Members of the internal audit department should confirm that they agree to abide by the code of conduct.

   9.2 The organization should provide guidance on the type and nature of interests which should be declared in a conflict of interest declaration. Internal auditors should declare interests in accordance with the requirements. The leader of internal audit should review these interests and plan allocation of work to minimize the risk of conflict of interest.

10. Internal audit should have the capacity to accomplish its responsibilities, have processes to maintain its auditors' skill, and collectively possess the requisite skills for all audits.

   10.1 The internal audit staff should have appropriate professional qualifications, skills and experience for their position.

   10.2 The internal audit staff should have opportunities to improve their qualifications or skills and should have targets for continuing professional education and confirm accomplishment of the targets on an annual basis.

   10.3 There should be peer working groups to share internal assurance and audit information and experience as well as emerging best practices.

   10.4 Processes should be in place to obtain and use external resources to supplement work provided by the internal audit department or to provide expertise.

   10.5 The internal auditors should engage only in those services for which they have the necessary knowledge, skills, and experience.

   10.6 Internal auditors should have sufficient knowledge to identify the indicators of fraud.

   10.7 Internal auditors should have knowledge of key information technology risks and controls and available technology-based audit techniques to perform their assigned work.

   10.8 In exercising due professional care the internal auditor should consider the use of computer-assisted audit tools and other data analysis techniques.

   10.9 The leader of internal audit should obtain competent advice and assistance if the internal audit staff lacks the knowledge, skills, or other competencies needed to perform all or part of the engagement.

11. Internal audit should comply with professional standards for developing criteria for audits; for planning, executing, and documenting audits; and reviewing audit files.

   11.1 The leader of internal audit should specify the required standard of internal audit documentation and working papers and ensure that those standards are maintained.

11.2 Internal auditors should develop and record a plan for each engagement. The audit plan for each audit should describe the objectives and scope of work, risks to the activity, how the risk is managed, how the audit will be carried out, timelines for work and reporting, and resources required.

11.3 Internal auditors should conduct a preliminary assessment of the risks relevant to the activity under review. Engagement objectives should reflect the results of this assessment.

11.4 Adequate criteria are needed to evaluate controls, governance processes and value-for-money. Internal auditors should ascertain the extent to which management has established adequate criteria to determine whether objectives and goals have been accomplished. If adequate, internal auditors should use such criteria in their evaluation. If inadequate, internal auditors should work with management to develop appropriate evaluation criteria.

11.5 Internal auditors should develop work programs that achieve the engagement objectives. These work programs should be recorded.

11.6 Work programs should establish the procedures for identifying, analyzing, evaluating, and recording information during the engagement. The work program should be approved prior to its implementation, and any adjustments approved promptly.

11.7 Internal audit working papers should be sufficiently complete and detailed to enable an experienced internal auditor, with no previous connection with the audit assignment, subsequently to ascertain from them what work was performed and to support the conclusions reached.

11.8 The leader of internal audit should have systems of review in place to ensure that auditors obtain and record sufficient evidence to support their conclusions and to demonstrate the adequacy of evidence obtained to support professional judgements.

12. Internal audit work should be carried out with due professional care.

12.1 Internal audit departments should have clear audit policies, procedures, standards and rules of business conduct. Policies and procedures should be established to guide the internal audit activity.

12.2 The engagement should be properly supervised to ensure objectives are achieved, quality is assured, and staff is developed.

12.3 Internal auditors should base conclusions and engagement results on sufficient, appropriate analyses and evaluations.

12.4 Internal audit should maintain objectivity and not assume management's responsibility.

13. The leader of the internal audit department should develop and carry out a quality assurance and improvement program.

    13.1 Internal reviews should consider the quality of the audit work, supervision, compliance with the standards, compliance with audit or procedures manuals, the way in which the internal audit department benefits the organization, and the achievement of performance standards.

    13.2 Following a review, the leader of internal audit should report the results of the review to the audit committee and develop an action plan for addressing any weaknesses identified.

    13.3 The reviews should be conducted according to a review program and should themselves be subject to the principles of objectivity and the acquisition of evidence contained in the standards.

    13.4 The Internal audit should establish the resources and skills required for the delivery of its long-term plan and develop strategies to obtain the resources and skills.

    13.5 The internal audit department should be subject to a regular external quality review undertaken by appropriately qualified and independent reviewers. The results of the review should be reported to the audit committee for appropriate action.

Sources used:

1. International Standards for the Professional Practice of Internal Auditing - The Institute of Internal Auditors
2. Internal Audit in Departments and Agencies - 2004 Report – Chapter 1 – Office of the Auditor General of Canada
3. Code of Practice for Internal Audit in Local Government in the United Kingdom
4. Standards for the Professional Practice of Internal Audit in Government Organizations – HM Treasury – UK
5. Government Internal Audit Standards – Good Practice Guide – (May 2002) HM Treasury – UK
6. Policy on Internal Audit – Treasury Board of Canada
7. Internal Auditing Standards – Why they Matter – (December 2004) The Institute of Internal Auditors UK and Ireland
8. Internal Audit in Health Authorities – 2004/2005 Report 4 - Auditor General of British Columbia
9. Trends in Australian and New Zealand Internal Auditing (2004) – Ernst & Young

Sample Key Performance Indicators

AUDITOR GENERAL Alberta

KEY PERFORMANCE INDICATORS

In the following list we provide alternative measures of performance that an internal audit department may use. In implementing a performance measurement system, internal auditors must conform to appropriate practice. For example, measure selection should be based on plan goals, targets should be set and departments must understand what they will do if targets are not met.

Source:
Group Internal Audit - Potential Key Performance Areas - Ernst & Young LLP, January 2003

KEY PERFORMANCE INDICATORS: SERVICE DELIVERY

1. Audit Plan
   - Reports issued compared to agreed\planned
   - Plan revisions
   - Budgeted hours compared to actual hours (variance)
   - Plan remaining compared to capacity

2. Quality Assurance
   - Results of Independent internal QA Review (every 6 months)
   - Results of Independent external QA Review (every 5 years)
   - Number of key risks identified
   - Number of 'best practice' recommendations made that are accepted/implemented by the organization

3. Productivity
   - Actual hours compared to benchmark (by categories)
   - Number of uncaptured hours (total & per team member)
   - Percentage coverage of total audit universe

4. Client Satisfaction
   - Number of reports in respect of which client feedback has not been received compared to total reports issued
   - Results of client feedback received
   - Timeliness of issuing of client satisfaction surveys

KEY PERFORMANCE INDICATORS: HUMAN RESOURCES

1. Recruitment and Selection
   - Actual recruitment compared to planned recruitment
   - Existing skills set (competencies) compared to requirements (in light of IA dept vision)
   - Extent of usage of 3rd party specialists

2. People
   - Actual compared to plan people (inc employment equity)
   - Actual capacity compared to plan recruitment

3. Career Management
   - Succession plan for key positions (variance)

4. Performance Management
   - Performance agreements
   - Performance Development Plans not in place
   - Distribution performance (i.e., ratings) and level of remedial actions identified & completed (especially for poor performers)
   - Timeliness and quality of coaching/counselling

5. Regulatory Compliance
   - Regulatory exceptions (significant deviations)

6. Team Health
   - Level of staff satisfaction

7. Training and Development
   - Training cost compared to budget
   - Training plan compared to actual training
   - Effectiveness of training provided

8. Remuneration Management
   - Benchmark against industry

9. HR Strategy
   - HR planned objective achieved

KEY PERFORMANCE INDICATORS: KNOWLEDGE MANAGEMENT:

1. Operational knowledge (including training)
   - Number of initiatives / principles introduced into the work culture
   - Responsiveness of staff to new knowledge concepts/initiatives

2. Knowledge Management Utilisation (including Tools)
   - Utilisation index
   - Knowledge Request feedback
   - Number of knowledge usage success stories

3. Content Management
   - Archiving statistics
   - Level of knowledge "gaps" identified and actions taken to address

4. Knowledge Management Strategy
   - Completed compared to proposed objectives

KEY PERFORMANCE INDICATORS: CLIENTS

1. Client Satisfaction
   - Number of issues requiring immediate attention
   - Level of client satisfaction

2. Client Interaction
   - Clients not visited in last 3 months
   - Major issues requiring follow up
   - Number of instances client seeks ad-hoc advice from the department

3. CRM Strategy
   - Level of client satisfaction compared to plan and previous year
   - Level of 'client education'/marketing of internal audit department to clients

KEY PERFORMANCE INDICATOR: FINANCE

1. Forecasting (and recoveries)
   - Forecast compared to Budget

2. Expense Management & Recoveries
   - Month Actual compared to Budget vs. Forecast

3. Finance Strategy
   - Budget to Audit Plan

KEY PERFORMANCE INDICATORS: TECHNICAL (IT)

1. Availability (server level)
   - Downtime (hours x people x average cost)

2. Problem & Incidents expectations
   - Number of policy violations
   - Inappropriate access
   - Theft \ loss of hardware
   - Loss of data
   - Number of days since last Business Continuity was planned\ tested
   - Results of user satisfaction survey

3. IT (Information Technology) Strategy
   - IT strategy planned objective achieved

KEY PERFORMANCE INDICATORS : QUALITY ASSURANCE

QUALITY ASSURANCE:

1. Third (3rd) Party Reliance
   - Number of audits not relied upon by External Audit
   - Reduction in external audit hours based on reliance on internal audit
   - Level of reliance internal audit places on other assurance providers

2. IIA Standards Compliance
   - Results of Independent internal QA Review (every 6 months)
   - Results of Independent external QA Review (every 5 years)

3. Quality Management
   - Number of engagements completed (final report issued) without signed off QA checklists
   - Level of client feedback satisfaction
   - Timeliness of client feedback forms sent to clients
   - Results of Independent internal QA Review (every 6 months)
   - Results of Independent external QA Review (every 5 years)

KEY PERFORMANCE INDICATORS: RESEARCH AND DEVELOPMENT

1. Methodology R&D
   - Number of Methodology Enhancements/Updates identified (that improve quality, efficiency, effectiveness etc of the service delivery process) and delivered (measured on 6 monthly basis; consider measuring for staff not in an R&D role)
   - Methodology & technology plan achievement

2. Technology Upgrades
   - Number of Technology Upgrades (measured annually)
   - Level of benefits upgrades have provided (e.g. efficiency gains)
   - Methodology & technology plan achievement